VZCZCXRO8625
PP RUEHDA
DE RUEHAK #6503/01 3310604
ZNR UUUUU ZZH
P 270604Z NOV 06
FM AMEMBASSY ANKARA
TO RUEHC/SECSTATE WASHDC PRIORITY 0065
INFO RUEATRS/DEPT OF TREASURY WASHDC
RHEHAAA/NSC WASHDC
RUEHIT/AMCONSUL ISTANBUL 1687
RUEHDA/AMCONSUL ADANA 1370

UNCLAS SECTION 01 OF 02 ANKARA 006503

SIPDIS

TREASURY FOR INT'L AFFAIRS - JROSE AND MNUGENT

SENSITIVE
SIPDIS

E.O. 12958: N/A
TAGS: EFIN TU
SUBJECT: UPTICK IN NERVOUSNESS IN TURKISH MARKETS

REF: ANKARA 6410

This cable has been coordinated with Congen Istanbul.

1.(SBU) Summary: In the run-up to key decisions on Turkey's EU accession, Turkish financial markets are showing signs of increased nervousness, with declines in the currency and equity markets in recent days. the uncertainty and constant headlines on the EU front, combined with thin, end-of-year trading and a heavy reliance on foreign investors, mean increased probability for bumpy weeks ahead. 2007 might be even more volatile, as investors seem more concerned with upcoming elections and regional instability. End Summary.

-- ---
Modest Correction in Currency and Equity Markets
-- ---

¶2. (SBU) Starting the week of November 13-17, Turkish financial markets, especially equities and foreign exchange, have been declining, albeit not precipitously. The IMKB-100 which stood at 39,627 on November 10, fell 3 percent that week and continued to be soft in recent days, closing at 38,077 Thanksgiving day.

¶3. (SBU) Beginning this week, the lira is showing signs of weakness, a notable change from its generally stable or strengthening trend this autumn. At the close November 17, the lira was at 1.4369 to the dollar and 1.8364 to the Euro, but had fallen to 1.4774 to the dollar at the November 23 close and 1.9146 to the Euro. The easing in the bond market has been less pronounced, with the yield on the benchmark August 13 2008 bond increasing from 20.76 November 10 to 21.56% November 23.

Contrary to Conventional Wisdom

¶4. (SBU) The modest but tangible sell-off is notable because it is contrary to the conventional wisdom in several respects. The news on the inflation front -- a key focus of investors since June -- has been in line with expectations over the last few weeks, culminating in the Monetary Policy Council's widely-expected decision November 23 to hold rates steady for the fourth month in a row. The release of a survey of inflation expectations also came in broadly in line with market predictions, with twelve-month inflation projected at 7% and 24-month inflation projected at 5%. The recent easing of oil prices should also be positive for the inflation outlook, and for Turkish risk in general since lower prices imply a lower current account deficit.

Turkey-specific Factors to the Fore

¶5. (SBU) The market softness represents a relatively infrequent disconnect from the tone in global Emerging Markets, with some other EM stock markets hitting records in recent days. This suggests Turkey-specific factors have come to the fore, particularly domestic politics and regional instability. This fall we have seen more foreign investor delegations in Ankara than at any time in memory and they are asking far more questions about politics and elections than about the economy or EU outlook. Though market analysts have not focused much on Iraq, continuing bad news out of Iraq may be a factor, with more and more local contacts and pundits focusing on the implications for Turkey of worsening instability.

Insouciance About EU Tensions?

¶6. (SBU) The increasingly bleak news on the EU front in the run-up to the December 14-15 EU Council meeting might have been expected to produce this kind nervousness in Turkish markets. Analysts and investors, however, have been insisting for monts that markets are not overly concerned about the EU problems, having fully priced in a freezing of several chapters but not a complete suspension of the accession process. The relative insouciance about the "train wreck" scenario may be reflected in the continued deal flow in Foreign Direct Investment. Recent tensions with the EU have been shrugged off by the likes of National Bank of Greece, Citigroup, GE Capital, and Alpha Bank of Greece, which announced its purchase of a stake in Alternatifbank on November 22. Even on November 22, representatives of a major U.S. hedge fund told us that in two days of meetings in Istanbul and Ankara, the EU issue was barely discussed.

¶7. (SBU) By November 23 and 24, however, analysts were starting to say markets would be more focused on EU developments in the coming

days, perhaps because they have treated potential EU problems in the same way they have handled IMF frictions in recent years -- betting until the last minute that both sides will blink to avoid a complete rupture. As the "last minute" approaches, some may be losing their sang-froid.

Foreign Investors Will be Key

¶8. (SBU) If we are entering a period of volatility, foreign investors' willingness to stay in the market will be key, much as in the May-June period. Since they were burned by their asset-liability maturity mismatches in May and June, Turkish banks have tended to keep much smaller holdings of the long end of the yield curve -- i.e. the benchmark 18 month bond. This has caused yields to remain at world-beating levels: over 20% in nominal terms which translates to over 13% in real terms based on inflation expectations. These yields have proven irresistible to international investors, still flush with liquidity that they have to invest, hence the steady stream of Turkey-bound investor delegations. Non-resident holdings of domestic debt securities were at an all-time high at the end of October, totaling YTL 32.3 billion ($22.3 billion). Likewise, two-thirds of the free float on the Istanbul stock exchange is held by non-residents.

¶9. (SBU) In addition to Turkish banks' reticence about longer-maturity bonds, a more anxious view held by local investors is perceptible from the trends in bank deposits. Whereas from 2002 through early 2006 the ratio of lira deposits to foreign currency deposits was on the rise, since the May-June volatility the trend has reversed, and picked up in recent weeks.

Critical Period Through mid-December

¶10. (SBU) It is far from clear whether the softening will continue or how big a role the EU "noise" is playing. The uncertainty and constant headlines on the EU front, combined with thin, end-of-year

trading and a heavy reliance on foreign investors, mean increased probability for bumpy weeks ahead, at least until the EU Council reduces the EU uncertainties and investors reopen positions at the start of the new year. Still, 2007 promises to be even more volatile, with investors more concerned about Turkey's May Presidential elections and November parliamentary elections than they are about the EU.

Wilson